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SUBJECT: SENIOR PRIVATE BANKER ON BRAZIL'S POLITICAL SCANDAL

REF: A. BRASILIA 2242, B. BRASILIA 2237, C. BRASILIA 2303, D. BRASILIA 2226

Classified By: Economic Counselor Bruce Williamson, Reasons 1.4
(b) and (d).

11. (C) Summary: In an August 23 conversation with Econoff, Banco Itau Executive Director Sergio Werlang, a leading financial markets expert and senior figure in Brazil's second largest private bank, dismissed market fears that Brazil's overall economic policy would change even if Finance Minister Palocci were forced to resign over allegations of financial misconduct during his tenure as mayor of Ribeirao Preto (refs A and B). Palocci's tenure is of secondary importance, in Werlang's view, as Lula himself has made it clear over the course of this drawn-out political scandal, that he would not be opting for a populist policy course even in the face of sliding popularity levels (refs C and D). Taking the argument a step further, Werlang stated that he is ever more convinced that even if Lula is impeached (a scenario which he assessed as only 30% probable) that there would be policy continuity under his successor and that the markets and Brazil's economy would handle the impeachment without significant disruptions. End Summary.

12. (C) Although the markets were unquestionably reassured by Palocci's credible denial of the allegations made against him, Werlang stated that he is personally more reassured by the fact that, as the political scandal grinds on, it has become obvious that Lula himself was not -- and in Werlang's view would not be -- opting for populist policies. While Lula's recent speeches to workers' groups that contained definite populist overtones, Werlang affirmed that the markets would judge the Lula administration by its actions. For example, instead of opening the budget spigots, the administration had run a primary surplus of over 5.1% of GDP in the twelve months through July 2005 and was seriously considering increasing the formal primary surplus target (currently 4.25% of GDP) for the year to serve as an anchor during this period of greater market volatility. Pointing to Lula's ultimate defeat of a congressional effort to raise the minimum wage, Werlang professed not to be worried that Lula would be unable to control congressional proposals for excessive spending.

13. (C) Based on what is publicly known about the scandal and Lula's reactions thus far, Werlang assessed the probability that Lula would be impeached to be about 30%. Werlang nevertheless stated that he is becoming more convinced that, even if Lula were impeached, Brazil's economy and financial markets would adjust without significant disruptions. He acknowledged there would be volatility in the financial markets but argued these would be temporary hiccups. The cornerstone of Werlang's argument was the recent statement by Chamber of Deputies President Severino Cavalcanti, an erratic populist who is second in line to replace Lula after Vice President Alencar, that if the presidency were to pass to him that he would fulfill his constitutional duties and call for an indirect, congressional vote to be held within 30 days to select a new president to serve out the remainder of Lula's term.

14. (C) Looking at potential candidates in such an election, Werlang stated that some analysts interpreted a subsequent speech by former President and current Senator Jose Sarney as the platform upon which he would run. Others had touted widely respected former Vice President (under Fernando Henrique Cardoso) Marco Maciel as a consensus choice. Werlang believed that Supreme Court President Nelson Jobim, whose name also has been mentioned in this context, would not run so as to keep open his option to try to seek the PMDB party nomination in the 2006 elections. Any of these figures would be solid choices from the economic policy point of view, Werlang said, and the fact that the markets had time to game out these scenarios was "healthy" for stability during a transition.

15. (C) The biggest potential fly-in-the-ointment for the markets and Brazil's economic stability, Werlang said, was that the Lula's political weakening and his slim chances for

re-election opened political space for a populist candidate in the 2006 presidential elections such as former Rio de Janeiro State governor Anthony Garotinho. While uncertain about the probability Garotinho would emerge as the PMDB candidate, he averred that it could not be discounted. (Note: currently, Garotinho is not eligible to make such a run as an electoral court judge stripped him of his political rights because of improper campaign practices in the October 2004 municipal elections; Garotinho has appealed the verdict.)

16. (C) Comment: We agree with Werlang that it bodes well for stability during a theoretical impeachment/transition that analysts have had time to game out these scenarios. That said, international investors without detailed familiarity with the players and processes may be less reassured than Werlang. We would therefore still expect a fair degree of volatility in any Lula impeachment or resignation scenario. Fortunately, Brazil's current solid economic fundamentals have given the Central Bank time to build international reserves. Just as importantly, the Brazilian Treasury has a cash operating reserve equal to over three months of its financing requirements. All this should reduce the impact of shorter term volatility.

17. (C) While Werlang downplays the negative impact of any potential departure by FinMin Palocci on the economy, other analysts are less sanguine. For instance, well-respected consultant Carlos Langoni sees Palocci's determination and influence with the President as "key for the success of the fiscal adjustment." Without Palocci, he argues, the consequences would be higher country risk, increasing volatility, backward steps on inflationary expectations and postponement or suspension of much needed investment. Palocci, Langoni believes, is irreplaceable.

DANILOVICH